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No. 279

In the Supreme Court of the United States

OCTOBER TERM, 1960

THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES, PETITIONER

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINION BELOW

The opinion of the Court of Claims (Pet. 1a-9a) is reported at 181 F. Supp. 241.

JURISDICTION

The order of the Court of Claims granting the Government's motion for partial summary judgment, and denying the taxpayer's cross-motion for partial summary judgment, was entered on March 2, 1960.

(Pet. 1a, 6a.) On May 24, 1960, this Court entered an order extending the taxpayer's time to file a petition for a writ of certiorari to and including July 30, 1960. The taxpayer filed its petition for a writ of certiorari on July 28, 1960. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTION PRESENTED

Whether the Court of Claims erred in holding that prepayment charges, paid to a life insurance company by borrowers for the privilege of prepaying the principal of their indebtedness before maturity, constituted taxable income to the insurance company as "interest" within the meaning of Section 201(c)(1) of the Internal Revenue Code of 1939 and its successor, Section 803(a)(2) of the 1954 Code.

STATUTES INVOLVED

Internal Revenue Code of 1939:

> SEC. 201 [As amended by Sec. 163(a) of the Revenue Act of 1942, chapter 619, 56 Stat. 798] LIFE INSURANCE COMPANIES.
>
> * * * *
>
> (c) *Other Definitions.*—In the case of a life insurance company—
>
> (1) *Gross income.*—The term "gross income" means the gross amount of income received during the taxable year from interest, dividends, and rents.
>
> * * * *

(26 U.S.C. 1952 ed. 201.)

Internal Revenue Code of 1954:

Subchapter L—Insurance Companies

PART I—LIFE INSURANCE COMPANIES

* * * *

SEC. 803. OTHER DEFINITIONS AND RULES.

(a) *Application of Section; Gross Income.*—

* * * *

(2) *Gross income.*—The term "gross income" means the gross amount of income received or accrued during the taxable year from interest, dividends, and rents.

* * * *

(26 U.S.C. 1952 ed., Supp. II, 803)

STATEMENT

The taxpayer is a life insurance company. In accordance with common practice, the taxpayer included in its long-term promissory notes and mortgage instruments, reflecting its loans to third parties, provisions imposing charges for the privilege of prepaying the principal of the loan before maturity. The taxpayer's prepayment charges ranged from 3% on principal amounts prepaid within five years of the loan to ¼ of 1% on principal amounts prepaid in the nineteenth year of the loan. During the taxable years 1950-1954 the taxpayer received in excess of $3,200,000 in mortgage prepayment charges and in excess of $1,700,000 in prepayment charges on promissory notes.

The Commissioner determined deficiencies against the taxpayer for the years 1950-1954, upon the ground that the taxpayer should have included the

prepayment charges in its gross income. Following the payment of these deficiencies and denial of its claim for refund, the taxpayer brought the instant refund suit. Both the taxpayer and the Government moved for partial summary judgment with respect to the issue involving the prepayment charges. The Court of Claims granted the Government's motion and remanded the case to its Commissioner for further proceedings on the taxpayer's other causes of action. (Pet. 6a.)

ARGUMENT

The issue presented is whether prepayment charges, collected by a life insurance company as lender for the privilege of prepaying loans prior to maturity, constitutes taxable income to the insurance company. Section 201(c)(1) of the Internal Revenue Code of 1939, *supra*, p. 2, and its successor, Section 803(a)(2) of the 1954 Code, *supra*, p. 3, define the taxable gross income of life insurance companies as "the gross amount of income * * * from interest, dividends, and rents." In the present case, the Court of Claims has held that the prepayment charges received by the taxpayer constituted "interest" within the meaning of Sections 201(c)(1) and 803(a)(2).

1. The decision below is correct, and the taxpayer errs in asserting (Pet. 10-12) that it is inconsistent with decisions of this Court and conflicts with a decision of the Fifth Circuit. As the court below held (Pet. 3a), in agreement with the recent decision in *General American Life Insurance Co.* v. *Commis-*

sioner, 25 T.C. 1265, prepayment charges constitute additional fees for the use of the lender's money for a shorter period of time than originally agreed upon, thus representing the higher cost of a short-term, as opposed to a long-term, loan. Prepayment charges are geared to the lender's costs in a manner designed to compensate it for the loss of interest income it would have received if the loan were outstanding to maturity. American Institute of Banking, *Home Mortgage Lending*, p. 141; Hoagland, *Real Estate Finance*, pp. 81, 243, 259, 405. Thus prepayment charges are, in fact, a part of the cost to the borrowers for the use of the lender's money. These charges are therefore "interest" within this Court's definition of the term for the purposes of the federal tax laws as "compensation for the use or forbearance of money." *Deputy* v. *duPont*, 308 U.S. 488, 498; *Old Colony R. Co.* v. *Commissioner*, 284 U.S. 552, 560-561. No narrower construction of the term "interest," as employed in defining the taxable income of life insurance companies, is required or suggested by the legislative history of these provisions or by any relevant decision. On the contrary, it is clear from legislative history, as recognized by the court below (Pet. 3a-4a), that the earliest predecessor of Section 201(c)(1) was enacted in 1921 in order to limit the income taxation of life insurance companies to their *investment* income, as distinct from their underwriting income.[1] Hence, the terms "interest, divi-

[1] See, more fully, Hearings before the Senate Committee on Finance, 67th Cong., 1st Sess., on H. R. 8245, pp. 83, 84;

dends, and rents" should be construed realistically to reach all investment income which falls within the described categories, unless it appear affirmatively that Congress did not intend to include a particular species of investment income. As this Court said in *Helvering* v. *Midland Ins. Co.*, 300 U.S. 216, 223: "The terms 'interest,' 'dividends,' and 'rents,' * * * were plainly used by Congress in their generic meanings, as broadly descriptive of certain kinds of 'interest.'"

It is evident, then, that the taxpayer errs in asserting inconsistency between the instant decision and the decisions by this Court in *Deputy* v. *duPont*, *supra*, *Old Colony R. Co.* v. *Commissioner*, *supra*, and allied cases; and the taxpayer is equally mistaken in asserting a conflict with *Campbell* v. *Great National Life Insurance Co.*, 219 F.2d 693 (C.A. 5). In the *Great National* case, the Fifth Circuit held that royalties did not constitute "rents" within the meaning of Section 201(c)(1). The court reached this decision upon the ground that, in its view, the word "rents" in its common and usual meaning does not include royalties; that Congress had often expressly distinguished between rents and royalties in revenue legislation; and that the failure of Congress to provide a depletion deduction with respect to royalties received by life insurance companies, although such

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61 Cong. Record, Part 5, p. 5342; H. Rep. No. 350, 67th Cong., 1st Sess., p. 14 (1939-1 Cum. Bull (Part 2) 168, 178); S. Rep. No. 275, 67th Cong., 1st Sess., p. 20 (1939-1 Cum. Bull. (Part 2) 181, 195); S. Rep. No. 617, 65th Cong., 3d Sess., p. 9 (1939-1 Cum. Bull. (Part 2) 117, 123).

a deduction is allowed for other taxpayers who must include royalties in their taxable income, constitutes an additional and highly persuasive indication that Congress did not intend to tax royalties in the hands of life insurance companies.[2] Thus the result reached in the *Great National* case, as well as its rationale, is not in conflict with the decision in the instant case.

2. The question is not one of continuing importance. Prepayment charges were made expressly taxable in the hands of life insurance companies by Section 2 of the Life Insurance Company Tax Act for 1955, Chapter 83, 70 Stat. 36, amending Section 803 (a)(2) of the 1954 Code, *supra*, p. 3, for years beginning after December 31, 1954. As for the four pending cases which the taxpayer cites (Pet. 3, n. 1) as involving the issue, two (*Metropolitan Life Ins. Co.* v. *United States*, C. Cls. No. 79-59, and *Prudential Ins. Co. of America* v. *United States*, C. Cls. No. 55-59) raise this issue only by way of setoff. Should the taxpayers in those two cases be unsuccessful in their suits for refund, the issue will not be reached since their taxable years prior to 1955 are closed for purposes of assessing deficiencies. It is

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[2] Here the taxpayer has taken as a deduction all expenses incidant to its assessment and collection of prepayment charges, as well as its expenses incident to placement of the loans giving rise to these prepayments.

[3] Judge Rives' dissenting opinion in the *Great National* case (219 F.2d at pp. 697-699) presents materials additional to those discussed in the text herein, confirming the intent of Congress to reach the investment income of life insurance companies, as distinguished from its underwriting receipts.

merely speculation to suggest that the issue will be raised and litigated for taxable years prior to 1955 with respect to many other life insurance companies.

3. The administrative practice, insofar as it supports the taxpayer's position at all, does so by reason of inaction rather than by any affirmative adoption of the construction urged by the taxpayer. In no general ruling has the Commissioner or the Department of the Treasury since the adoption of the law in 1921 expressly excluded prepayment charges from the taxable income of insurance companies. The granting of claims for refunds in two isolated cases referred to by the petitioner (Pet. 6) for the years 1921 and 1922 fall far short of constituting an established administrative practice. See *Automobile Club* v. *Commissioner*, 353 U.S. 180. Moreover, there is no indication whatsoever that such action ever came to the attention of Congress.[4]

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[4] The petitioner's references to Article 671 of Treasury Regulations 62, promulgated in 1922, and to Bulletin H published in 1921 (Pet. 4-5), confuse, rather than clarify, the issue. Although the regulations define gross income of insurance companies by reference to items 25-31 of the income page of the annual statement for life companies (edition 1920), they can hardly have reference to the items listed in Bulletin H since that would result in excluding from taxable income not only prepayment fees (item 36), but also gross interest on mortgage loans (item 21). Actually item 36 of the insurance companies' statement included in Bulletin H is a blank line following item 35 which introduces it as "[Income] From other sources." The Bulletin, published prior to the Revenue Act of 1921 and having no relation to such Act, undertook to give examples of such income. There is no indication that in adopting Article 671 of Regulations 62 in 1922 there was an intention to

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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adopt this interpretation applicable to a different statute and to a different edition of the annual statement for life companies.